

ICBC's CAPITAL RESERVE MINIMUMS ARE TOO HIGH

The new provincial government is struggling to keep ICBC rates affordable, while at the same time attempting to restore the public insurer's finances to a satisfactory financial condition.

Minister responsible David Eby, while apparently ruling-out a shift from the expensive tort model to a no-fault model, has said that the government is open to reasonable suggestions for reform to the financially unsustainable auto insurance system.¹

The government should question the current regulatory minimum targets for the Basic and Optional capital reserves. These minimum targets were established in the early 2000's to protect the taxpayer from liability for claims arising from the normal operation of the Basic and Optional programs.

Reducing the targets to better reflect current risks would redefine a satisfactory financial condition, and relieve some of the current pressure to increase premiums and/or reduce coverage. In time, and in combination with other reforms, the reduced targets could result in lower insurance premiums.

The Purpose of the Capital Reserve²

A capital reserve “mitigates the risk of insolvency and protects the interests of ratepayers, and claimants. It ensures that Basic insurance is sufficiently capitalized to provide reasonable comfort that it will be able to meet its policyholder obligations.”³ An adequate reserve should protect policyholders from rate shocks due to unexpected variances from forecasted results and due to events and losses arising from non-recurring events or factors.

How to Determine an Appropriate Capital Reserve⁴

The size of the reserve should be larger for an insurer subject to market competition compared to a publicly owned insurer, which operates as a monopoly (or near monopoly

¹ BC Hansard, 7 November 2017, p. 1890-91.

² For a more detailed discussion of the capital reserve see http://www.bcuc.com/Documents/Arguments/2015/DOC_43293_03-12-2015_McCandless_Final-Argument.pdf p. 6.

³ Manitoba Public Utilities Board, <http://www.pubmanitoba.ca/v1/proceedings-decisions/orders/pubs/2017%20orders/130-17.pdf> p. 78.

⁴ A useful discussion about the considerations underpinning the adequacy of the capital reserve for the Manitoba Basic insurance program is found at http://www.pubmanitoba.ca/v1/proceedings-decisions/appl-current/pubs/2018%20mpi%20gra/cac-5%20-%20does%20the%20rsr%20need%20to%20be%20so%20large_to%20file.pdf

as in the case of the Optional coverage⁵), and operates as an agent of the provincial government.

What size of reserve is adequate? The MPUB determined that “the public interest is best protected by setting an appropriate upper threshold to meet the risks of unforeseen events. This must be balanced against the opportunity cost created by ... retaining capital that would otherwise be retained by ... ratepayers.”⁶

Federally regulated insurers must adhere to the Office of the Superintendent of Financial Institutions (OSFI) minimum capital test (MCT) requirements, which use a risk adjusted formula to calculate the capital reserve target level. If OSFI determines that the capital reserve is insufficient it may place the insurer under administration.

A second method to determine the appropriate size of the capital reserve is a solvency test, known as the Dynamic Capital Adequacy Test (DCAT), developed by the Canadian Institute of Actuaries. The DCAT method “stress tests” the available capital using reasonable future adverse scenarios to determine if there is sufficient capital set aside to avoid insolvency.

In 2003/04, the BC government adopted the federal MCT method and required that the minimum Basic capital reserve would be funded at the 100% MCT ratio, and the Optional reserve would have a 200% ratio. The Basic 100% minimum target was lower than the OSFI requirement as it recognized the monopoly nature of the compulsory Basic insurance. The Optional minimum was chosen to provide a form of equity with the private insurers to ensure that ICBC would not enjoy a pricing benefit through a lower capital requirement.

ICBC had been using a modified solvency test to measure the adequacy of the Basic reserve, but defined solvency as the 100% MCT ratio. This approach, of course, indicated that a large capital reserve was required. In 2007, the BC Utilities Commission accepted this approach and set the working level for the Basic capital reserve working level (the management target) at 130%. In 2013 the BCUC increased the target to 145% after the government capped the annual increase in Basic rates.⁷

Ernst Young Report of 2017

In its July 2017 report, Ernst & Young questioned whether the current capital management targets were overly conservative (high). Unfortunately, the Ernst Young discussion respecting the capital calculation was confusing, and even suggested that lower targets could result in a capital surplus that could be used by the government. This

⁵ ICBC enjoys approximately 90% of the Optional market, and the Manitoba Public Insurance has approximately 95% of the extension (Optional) market in that province.

⁶ Manitoba Public Utilities Board, <http://www.pubmanitoba.ca/v1/proceedings-decisions/orders/pubs/2017%20orders/130-17.pdf> p. 78.

⁷ ICBC had recommended 150%. In 2016 cabinet took over the authority to set the capital target, see OIC 605/16 of August 2016.

statement ignores the fact that the capital belongs to the policyholders and not to the taxpayers.⁸

But the report did note that a lower management (and regulatory) target would lessen the pressure on premiums to fund a large capital reserve.

Rate Suppression Policy Depletes Capital Reserves

The previous Liberal government's policy of underpricing Basic insurance caused a significant decline in both the Basic and Optional capital reserves. Appendix A shows that between 2012 and the forecasted 2018/17 year-end approximately \$1.2 billion will be consumed, including \$514 million appropriated by the government.

The minimum Basic reserve was maintained by the addition of significant financial transfers from the Optional program, including \$569 million for fiscal year 2017/18. By 31 March 2018, the Optional capital reserve is forecast to have declined to \$545 million, or some \$955 million below the 200% minimum ratio required by regulation.

ICBC's New Basic Program Forecast

ICBC's 28 November 2017 multi-year financial forecast for the Basic program⁹ showed continuing major comprehensive income losses, resulting in the Basic capital reserve falling to \$245 million by year-end 2020/21 (see Appendix A, Table 2).

ICBC did not provide a forecast for the Optional program.

The structural deficit in the Basic program results in annual capital losses of approximately \$400 million. Each year the gap between the regulatory minimum capital requirement and the capital available widens (the MCT formula also adds to the gap if unpaid claims and other liabilities increase). This can be characterized as the "insolvency spiral."

Table 1 (from Appendix B) shows the approximate gap between the management target, the minimum regulatory target and a proposed reduced minimum regulatory target for fiscal years 2018/19 to 2020/21. The forecast in Table 3 was derived from the information available, and includes reasonable assumptions about the annual change in comprehensive income.

If a satisfactory financial condition is defined as matching the management targets, then the Basic capital deficiency for 2018/19 would be approximately \$1.46 billion, while the Optional shortfall would be \$1.87 billion.

⁸ <http://www.icbc.com/about-icbc/company-info/Documents/Affordable-and-Effective-AutoInsurance-Report.pdf> p. 85.

⁹ The forecast assumed a cumulative rate increase of 31% in Basic rates during these three years; see BCUC, ICBC 2017 RRA, IR 1, RM 1.6. This

**Table 1 – Capital Target Shortfall Scenarios
(\$=million)**

	2018/19	2019/20	2020/21
BASIC @ 145%	1,460	1,870	3,005
@ 100%	680	1,290	1,995
@ 80%	330	885	1,545
OPTIONAL			
@ 250%	1,250	1,360	1,425
@200%	850	930	1,000
@150%	450	540	540

Lowering the minimum regulatory targets (to 80% for Basic and 150% for Optional) reduces the gap significantly, and avoids even higher rate increases and/or more severe reductions in insurance coverage.

Lower Minimum Capital Targets Lowers Pressure on Policyholders

Lowering the Basic capital ratio of 80% reduces the 2018/19 capital deficiency to \$330 million, compared to the \$680 million required if the target ratio remained at 100%. The Optional deficiency would be reduced to \$450 million from the \$850 million if the 200% ratio is maintained.

If the Basic capital deficiency of \$330 million was made up solely through a premium increase, a rise of approximately 10% (2017/18 dollars) will be required (in addition to the 7.9% increase already assumed in the ICBC forecast). Or, a combination of other revenue and expenditure reduction measures saving the \$330 million would be required.

In my Occasional Paper of 4 December 2017, I suggested that the government should reimburse Basic policyholders approximately \$200 million for programs where the government is the main beneficiary, or is the result of a government policy.¹⁰ If the government agreed to this funding the remaining expenditure reduction required would be \$130 million.

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The writer is a retired senior BC government public servant whose paper describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014 was published by *BC Studies* in November 2016. *BC Studies* published his paper on the 40-year financial history of ICBC in 2013. He has been an intervener in the BC Utilities Commission's recent reviews of ICBC's rate requests, and is an intervener in the Commission's current review BC Hydro's rate request

¹⁰ See

http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_47_4_december_2017/pdf
Capping certain pain and suffering claims may produce the savings, but would probably not result in enough savings to actually lower the 7.9% indicated premium increase for 2018.

APPENDIX A – THE CAPITAL RESERVES FORECAST

Table A.1 – Change in Combined Capital by Year (\$=million)

	-----INITIAL-----			-----REPORTED-----		
	\$	MCT%	To Prov.	\$	MCT%	1% MCT
2012	3,247	200	--	3,247	200	16.2
2013	3,880	218	(237)	3,643	204	17.8
2014	3,755	205	(139)	3,616	193	18.3
2015	3,284	164	(138)	3,146	157	20.0
2016/17	2,446	112	--	2,446	112	21.8
2017/18	2,030	e86	--	2,030	e 86	e23.5
2018/19	1,809	e73	--	1,809	e73	e25.0
2019/20	1,520	e58	--	1,520	e58	e26.2

Source: Derived from ICBC annual reports, with estimates for 2017/18 to 2019/20 derived from ICBC's September 2017 updated service plan.

Notes: The MCT ratios for 2017/18 to 2019/20 were not provided by ICBC in its September 2017 service plan; these are my estimates based on the trends in recent years.

Table A.2 – Change in Basic Capital by Year (\$=million)

	-----INITIAL-----			-----REPORTED-----		
	\$	MCT	Fm Option	\$	MCT	1% MCT=
2012	1,054	101	373	1,427	137	10.4
2013	1,603	139	113	1,716	149	11.5
2014	1,633	136	--	1,633	136	12.0
2015	1,071	83	--	1,071	83	12.9
2016/17	633	45	823*	1,456	103	14.1
2017/18f	916	62	569**	1,485	101	14.7
2018/19f	1,061	61	--	1,061	61	17.4
2019/20f	730	36	--	730	36	20.2
2020/21f	245	11	--	245	11	22.4
2021/22f	(110)	(4)	--	(110)	(4)	27.7

Source: Derived from ICBC annual reports (2016/17 is 15 months), with estimates for 2017/18 to 2021/22 derived from BCUC, ICBC 2017 RRA, IR 1, RM 1.6; see

http://www.bcuc.com/Documents/Proceedings/2017/DOC_50367_B-2_ICBC-Responses-to-IR-1.pdf

Notes: * Includes a \$450 million transfer in January 2016, \$201 million of Optional operating and \$172 million of capital transferred during the year.

** Includes \$99 million form Optional transferred after the close of 2016/17, and \$470 million transferred as part of the Basic rate requirements application for calculating the 2017 Basic rate increase.

Table A.3 – Change in Optional Capital by Year (\$=million)

	----INITIAL----		----TRANSFER----		---REPORTED----		
	\$	MCT	To Prov.	To Basic	\$	MCT	1% MCT=
2012	2,193	378	--	(373)	1,820	313	5.8
2013	2,277	361	(237)	(113)	1,927	305	6.3
2014	2,122	319	(139)	--	1,983	298	6.65
2015	2,213	321	(138)	--	2,075	301	6.9
2016/17	1,813	252	--	(823)*	990	138	7.2
2017/18f	1,114	149	--	(569)**	545	73	7.5
2018/19f	749	94	--	--	749	94	8.0
2019/20f	790	92	--	--	790	92	8.6
2020/21f	850	93	--	--	850	93	9.1

Source: Derived from ICBC annual reports, with estimates for 2017/18 to 2021/22 derived from BCUC, ICBC 2017 RRA, IR 1, RM 1.6; see

http://www.bcuc.com/Documents/Proceedings/2017/DOC_50367_B-2_ICBC-Responses-to-IR-1.pdf

Notes: * Includes a \$450 million transfer in January 2016, \$201 million of Optional operating and \$172 million of capital transferred during the year.

** Includes \$99 million form Optional transferred after the close of 2016/17, and \$470 million transferred as part of the Basic rate requirements application for calculating the 2017 Basic rate increase.

APPENDIX B – THE CAPITAL SHORTFALL: THREE CAPITAL TARGET LEVELS

Capital forecasts from Appendix A.

Scenario 1 are the current capital management targets of 145% Basic and 250% Optional. Scenario 2 are the regulatory minimum targets of 100% Basic and 200% Optional. Scenario 3 are the reduced capital targets of 80% Basic and 150% Optional.

FISCAL YEAR 2018/19**SCENARIO 1—THE MANAGEMENT TARGET LEVELS**

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	2,520	145	2,000	250	4,520
Forecast	1,060	61	750	94	1,810
Shortfall	(1,460)	(84)	(1,250)	(156)	2,710

SCENARIO 2—THE REGULATORY TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	1,740	100	1,600	200	3,340
Forecast	1,060	61	750	92	1,810
Shortfall	(680)	(39)	(850)	(106)	(1,530)

SCENARIO 3—THE REDUCED TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	1,390	80	1,200	150	2,590
Forecast	1,060	61	750	94	1,810
Shortfall	(330)	(19)	(450)	(56)	(780)

FISCAL YEAR 2019/20**SCENARIO 1—THE MANAGEMENT TARGET LEVELS**

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	2,930	145	2,150	250	5,080
Forecast	1,060	61	790	92	1,850
Shortfall	(1,870)	(84)	(1,360)	(158)	3,230

SCENARIO 2—THE REGULATORY TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	2,020	100	1,720	200	3,740
Forecast	730	36	790	92	1,520
Shortfall	(1,290)	(64)	(930)	(108)	(2,220)

SCENARIO 3—THE REDUCED TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	1,615	80	1,290	150	2,905
Forecast	730	36	790	92	1,520
Shortfall	(885)	(44)	(540)	(58)	(1,385)

FISCAL YEAR 2020/21

SCENARIO 1—THE MANAGEMENT TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	3,250	145	2,275	250	5,525
Forecast	245	11	850	92	1,095
Shortfall	(3,005)	(134)	(1,425)	(158)	4,430

SCENARIO 2—THE REGULATORY TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	2,240	100	1,840	200	4,080
Forecast	245	11	840	91	1,085
Shortfall	(1,995)	(89)	(1,000)	(109)	(2,995)

SCENARIO 3—THE REDUCED TARGET LEVELS

	BASIC		OPTIONAL		TOTAL
	\$	MCT	\$	MCT	\$
Target	1,790	80	1,380	150	3,170
Forecast	245	11	840	91	1,085
Shortfall	(1,545)	(69)	(540)	(59)	(2,085)

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